SUPREME COURT, U.S.

Office-Supreme Court, U.S.
FILED
FEB 9 1962
JOHN F. DAVIS, CLERK

No. 602

In the Supreme Court of the United States

OCTOBER TERM, 1961

LENORA SHERLOCK, INDIVIDUALLY AND AS EXECUTRIX OF THE ESTATE OF CHRIS J. SHERLOCK, DECEASED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (R. 21–32) is reported at 34 T.C. 522. The majority and dissenting opinions of the court of appeals (Pet. Ex. A, pp. 1–11) are reported at 294 F. 2d 863.

JURISDICTION

The judgment of the court of appeals was entered on September 27, 1961 (Pet. Ex. A, p. 12). Taxpayer's petition for rehearing was denied on October 30, 1961 (Pet. Ex. B). The petition for a writ of certiorari was filed on December 11, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the two courts below properly decided that, where taxpayer [1] had sold his interest in a partnership for a lump sum, the amount of taxpayer's share of the undistributed profits of the partnership, which profits had accrued prior to the effective date of the sale, was taxable to him as ordinary income.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations involved are set forth in the Appendix, *infra*.

STATEMENT

On June 1, 1951, taxpayer and two others organized a partnership which performed engineering and architectural services. The partnership agreement provided that the profits and losses should be borne equally, that any partner could withdraw from the firm upon prescribed notice, and that, in the event of such a withdrawal, the remaining partners would have an option to discontinue the business or to purchase the interest of the withdrawing partner. The partnership kept its books and records on the basis of a fiscal year ending April 30, and on the accrual method of accounting. (R. 23; Pet. Ex. A, p. 2.)

On February 26, 1954, taxpayer executed a bill of sale to his partners conveying to them his one-third interest in the partnership for $70,000 (R. 23–24;

[1] Lenora Sherlock is a party to this action as executrix and individually as a co-signer of a joint return. Consequently, as used in this brief, the term "taxpayer" refers to Chris J. Sherlock.

Pet. Ex. A, p. 2). The bill of sale stated (R. 24; Pet. Ex. A, pp. 2–3):

> 3. The books of the firm will be closed as of February 28, 1954, and seller withdraws as member of the firm and buyers will prepare, as soon as possible thereafter, returns of the income reflecting the profit and loss of the partnership for the period beginning June 1, 1953, and ending February 28, 1954. The profit between Chris J. Sherlock, Moreland Smith and Richard Adams; said returns shall be filed with the respective Governments and each of the parties will report their respective income from the partnership as shown by such returns. It is agreed that the profit and loss shown by such partnership to be the profit and loss of Sherlock has been received by him either through previous withdrawals or in the purchase price paid or to be paid by buyers.

Pursuant to provision 3 of the bill of sale, the partnership closed its books of account on February 28, 1954, and filed a return for the period May 1, 1953, to February 28, 1954. The return reported that the partnership income for the period was $249,827.38, that taxpayer's share of the income was $83,275.79, that the amount of his capital account in the partnership at the beginning of the period was a deficit balance of $9,641.59 (reflecting overdrafts), and that at the end of the period he had a credit balance of $49,303.80. (R. 24–25; Pet. Ex. A, p. 3.)

On the joint return filed by taxpayer and his wife for 1954, taxpayer reported the entire amount of the $70,000 paid to him for his partnership interest as a long-term capital gain computed with a zero basis,

but failed to report any amount of his distributive share of the partnership income for the period May 1, 1953, to February 28, 1954, as ordinary income. (R. 25; Pet. Ex. A, p. 3.) The Commissioner, in his notice of deficiency, determined that taxpayer should have included as ordinary income $83,275.78—his distributive share of the reported partnership profits for that period. The Commissioner also determined that the balance of taxpayer's capital account at the end of the period (*viz.*, $49,303.80) constituted taxpayer's basis in his partnership interest and should have been deducted from the $70,000 received by him for the sale of that interest, thereby reducing the amount of his reported capital gains (R. 14–17).

Subsequently, at the hearing, the parties stipulated that the correct amount of the partnership's income for the period May 1, 1953, to February 28, 1954, was $147,827.38; that taxpayer withdrew $14,233.95 during that period; and that his capital account at the beginning of the period had been overdrawn in the amount of $9,641.59 (R. 25–26; Pet. Ex A, pp. 3–4). Since the amount of taxpayer's deficiency had been computed on the basis of the income originally reported by the partnership, taxpayer's liability had to be recomputed (R. 27–28).

The Tax Court sustained the Commissioner's determination after making due allowance for the smaller partnership income stipulated by the parties (R. 21–32). Accordingly, the court included in taxpayer's ordinary gross income $49,275.79—the amount of taxpayer's distributive share of the partnership's profits

for the period in question, computed on the basis of the stipulated amount of partnership profit (R. 29). This resulted in a deficiency for the year 1954 of $19,372.54 (R. 33).[2] The court of appeals affirmed (Pet. Ex. A, p. 9).

ARGUMENT

The decisions of the two courts below are correct; there is no existing conflict; and the issue here involved is of no future importance. Further review is unwarranted.

1. The effective date of the termination of taxpayer's interest in the partnership was February 28, 1954. Taxpayer was therefore entitled to share in the partnership's profits until that date. (R. 24.) The parties stipulated that the ordinary income for the partnership for the fiscal year beginning May 1, 1953, and ending February 28, 1954,[3] was $147,827.38 (R. 34). Taxpayer was entitled to receive one-third of that amount—$49,275.79 (R. 23, 28).

Section 182 of the Internal Revenue Code of 1939, App., *infra*, provides that a partner must include in the computation of his gross income his distributive share of the ordinary net income of the

[2] The court also imposed penalties totalling $1,813.16 for the substantial underestimation of estimated tax and for failure to make timely payment of the amount of tax that was estimated. Taxpayer does not contest the imposition of those penalties in his petition.

[3] Because of taxpayer's retirement, the partnership filed a short-year return (R. 24–25). The income reflected accounts receivable entered on the partnership's books, which amounts had accrued to the partnership (which reported its income on the accrual basis) (R. 23).

partnership "whether or not distribution is made to him." See Treasury Regulations 118, Sec. 39.182–1, App., *infra*. Consequently, taxpayer was charged with his share of the partnership's profits up to the date of his withdrawal ($49,275.79), and he could not escape the tax liability that he had already incurred merely by selling his partnership interest. See Treasury Regulations 118, Sec. 39.113(a)(13)–2, App. *infra; Watson* v. *Commissioner*, 345 U.S. 544; *United States* v. *Snow*, 223 F. 2d 103 (C.A. 9th), certiorari denied, 350 U.S. 831; *Tunnell* v. *United States*, 259 F. 2d 916 (C.A. 3d); *Leff* v. *Commissioner*, 235 F. 2d 439 (C.A. 2d).

2. Contrary to taxpayer's contention (Pet. 4–5), there is no conflict among the courts of appeals on the question here involved. Taxpayer attempts to characterize the question as whether a lump sum payment received in consideration for the sale of a partnership interest must be treated as gain from the sale of a capital asset or whether such amounts of that sum which are attributable to the assignment of *future* income of the partnership may be treated as ordinary income. But that is not the issue in this case; the Commissioner has never disputed that the sale by taxpayer of his partnership interest (exclusive of his distributive share of the partnership income) was a sale of a capital asset (R. 30–31, 45–46). The Commissioner's contention, which was sustained by the courts below, is that the taxpayer's distributive share of the partnership income for the taxable period May 1, 1953, to February 28, 1954, was includible in his income for

that year under Section 182 of the 1939 Code, and the subsequent sale of his interest did not relieve him of that liability. See e.g., *United States* v. *Snow*, *supra*; *Watson* v. *Commissioner*, *supra*. Consequently, with the exception of *Meyer* v. *United States*, 213 F. 2d 278 (C.A. 7th), the cases cited by taxpayer (Pet. 4) are inapposite.[4] The *Meyer* case, in turn, is inconsistent with, and was therefore implicitly overruled by the more recent decision of the Seventh Circuit in *Hulbert* v. *Commissioner*, 227 F. 2d 399.[5]

3. In any event, the question here involved is of no continuing importance since it has been definitively re-

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[4] None of the other cases cited by taxpayer involved a situation where the income had been accrued by the partnership prior to the sale and was, therefore, distributable to the partner. For example, in *Swirin* v. *Commissioner*, 183 F. 2d 656 (C.A. 7th), certiorari denied, 340 U.S. 912, and *United States* v. *Donoho*, 275 F. 2d 489 (C.A. 8th), the partnerships reported on the cash basis. The contention of the government in those cases was that part of the selling price of the partnership interest represented an assignment of future income which was already earned.

Similarly in *Berry* v. *United States*, 267 F. 2d 298 (C.A. 6th), the partnership reported on the completed contract basis, and the sale was made before the contract was completed. Indeed, the court distinguished the *Snow*, *Leff* and *Tunnel* cases on that ground (267 F. 2d at 301).

United States v. *Shapiro*, 178 F. 2d 459 (C.A. 8th), involved the question whether the part of the selling price of a partnership interest which was attributable to the sale of noncapital assets should be treated as ordinary income. Although part of the selling price also reflected accumulated profits of the business, that amount was not involved in the litigation.

[5] See the dissenting opinion of Judge Lindley in *Hulbert* (227 F. 2d at 402) in which he states that the majority decision is irreconcilable with the *Meyer* case.

solved by Section 751 of the Internal Revenue Code of 1954, which provides that the amount of the selling price of a partnership interest that is attributable to either (1) unrealized receivables of the partnership or (2) inventory items which have appreciated substantially in value is treated as ordinary income. See also Section 1221(4) of the 1954 Code; H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 65, 70–72 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4091, 4096–4099).

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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FEBRUARY 1962.

APPENDIX

Internal Revenue Code of 1939 (26 U.S.C. 1952 ed.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

(a) [as amended by Section 9(c)(1) of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231] *General Rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (b), (c), and (d).

SEC. 187. PARTNERSHIP RETURNS.

Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each

individual. The return shall be sworn to by any one of the partners.

Treasury Regulations 118:

Sec. 39.113(a)(13)–2. *Readjustment of partnership interests.*—(a) When a partner retires from a partnership, or the partnership is dissolved, the partner realizes a gain or loss measured by the difference between the price received for his interest and the sum of the adjusted cost or other basis to him of his interest in the partnership plus the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid. * * *

* * * * *

Sec. 39.182–1. *Distributive shares of partners.*—(a) Each partner is required to include in his return for his taxable year within which or with which the taxable year of the partnership ends, whether or not distributed:

(1) As part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than six months.

(2) As part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than six months.

(3) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b).

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1942